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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
Rate Regulation	)	

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COMMENTS OF DISCOVERY COMMUNICATIONS, INC.

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Discovery Communications, Inc. ("Discovery") by its attorneys, hereby submits its comments on the Commission's Report and Order and Further Notice of Proposed Rulemaking[1] in the above captioned proceeding. In this proceeding, the Commission has solicited comments on the adoption of its final cost-of-service rules.

I. INTRODUCTION AND SUMMARY

Founded in 1985, The Discovery Channel features nonfiction documentaries about science, nature, technology, human events, and history. In 1991, Discovery acquired The Learning Channel, which features educational programs for viewers of all ages on subjects such as history, science, archeology, and anthropology. Discovery's mission for both channels is to use the power of television to educate and entertain viewers.

[1] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, FCC 94-39 (released Mar. 30, 1994) ("Report and Order" or "Further Notice").

As a major cable programmer, Discovery's interest in this proceeding is in the Commission adopting rate regulatory policies that provide cable system operators with adequate financial incentives to upgrade and expand their systems, and to add new programming. Discovery is concerned that the Commission's cost-of-service regulations will harm the public interest by creating powerful disincentives for cable operators to invest in diverse, high quality programming. The diversity and quality of programming is positively correlated with the incentives for operators to invest in programming. In order to promote the public interest by creating the necessary incentives for cable operators to support and carry diverse, high-quality programming, the Commission should modify its proposed rules in three crucial ways:

- The Commission should recognize that the affiliate transaction rules that were created for the telephone industry are inappropriate for the cable industry;
- the Commission should increase its proposed 11.25 percent rate of return; and
- the Commission should not adopt a productivity offset.

II. THE PROPOSED AFFILIATE TRANSACTION RULES ARE NOT NEEDED AND WOULD UNNECESSARILY IMPEDE THE ABILITY OF MANY CABLE OPERATORS TO RECOVER LEGITIMATE PROGRAMMING COSTS

In the First Report and Order, the Commission adopted interim rules to govern the accounting of transactions between cable operators "who either elect cost-of-service regulation or seek to adjust benchmark/price cap rates for affiliated programming cost"[2] and the programmers with whom they are affiliated. The affiliate transaction rules, which are based on rules adopted for regulated telephone companies, treat the sale of programming as the sale of an asset. Specifically, the rules provide that when an affiliate sells an "asset" (i.e., a program service) to an operator, "the asset[] shall be valued at the asset provider's prevailing company price, if the provider has sold the same kind of asset to a substantial number of third parties at a generally available price."[3]

In the Further Notice, the Commission has proposed to codify the interim rules, and also has proposed to prohibit the use of the prevailing company price to value transactions between affiliates whenever an affiliated programmer sells less than 75 percent of its total output to nonaffiliated cable operators.[4] In those circumstances, the affiliated operators would be required to value the program service at the lower of net book value or fair market value -- an amount that would almost always be less than the prevailing company price.

These proposed rules ignore significant differences between the cable and telephone industries. If applied to the cable industry they will have significant unintended consequences that will disserve the public interest. Accordingly, they should not be adopted.

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2 Report and Order at ¶ 262.

3 Id. at ¶ 263.

4 Further Notice at ¶ 311.

A. Cable Programmers Face Significantly Different Incentives Than Those Faced By Telephone Company Affiliates

In considering whether affiliate transaction rules are needed, the Commission should recognize the historical differences between cable programmers and traditional telephone company affiliates. In particular, the Commission should recognize that there is no history of abuse in cable affiliated transactions, perhaps in large part due to the unique characteristics of cable services.

In the telephone industry, affiliated entities were established to serve captive markets. For example, a regulated telephone entity would often create a wholly-owned subsidiary for the specific purpose of providing goods or services to its customers, including the regulated telephone company, on an unregulated basis. As a result, the affiliate relationships that developed in the common carrier area presented enormous opportunities and incentives for abuse.[5] In order to prevent cross-subsidization, the Commission devised restrictive rules to govern the relationship between telephone company affiliates.

In contrast, a cable programmer, such as Discovery, that is affiliated with a cable operator stands in a quite different posture. Unlike the telephone company affiliates, cable programmers were not created by regulated operators to provide

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[5] The breakup of AT&T and the recent NYNEX/MECO scandal typify the types of abuses that necessitated adoption of an affiliate transaction policy. See New York Tel. Co. and New England Tel. Co.: Violations of Commissions's Rules, 5 FCC Rcd. 5892 (1990).

unregulated services to captive customers; instead, the primary goal of any programmer, including those that have an affiliation with an operator, is to maximize its distribution and viewership. The programmer sets its prevailing company price at a level that it anticipates will help it reach the largest number of subscribers.[6] This is true for advertiser-supported services such as The Discovery Channel, as well as for premium channels.

Hence, for a programmer such as Discovery, sales to affiliated operators are nothing more than a necessary by-product of the business objective of maximizing distribution. The fact that the sale is to an affiliate rather than to an independent cable operator is, from the perspective of the profit maximizing programmer, wholly irrelevant. Thus, there is no reason why the cable operator should not be able to base its rates on a prevailing company price charged to it by an affiliated programmer.

B. The Commission's Proposed Rules Ignore Unique Public Policy Considerations Present in the Cable Industry

Public policy considerations present in the cable industry, but absent in the telephone business, also cast doubt on the wisdom of the proposed affiliate transaction rules. Most notably, cable operators have historically provided a significant degree of financial support to programmers, particularly during the early stages of the programmers' development. Discovery's own existence serves as a prime example. Had Discovery not received the financial support of several cable operators during its

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[6] This helps to explain the absence of any history of abuse of affiliate transactions in the cable industry.

early years, it is unlikely that it would have evolved into the highly acclaimed service that it is today. Other programmers similarly owe their current existence to the financial support of cable operators.

Over the years, numerous cable operators have provided the financial support necessary for new program services. As a result, many programmers are "affiliated" with more than one cable operator.[7] The Commission's proposed rules consequently would affect a larger number of operators than might be expected and would force them to pay more for programming, in the form of the programmer's prevailing company prices, than they could recover in their rates, where the programming would be valued at book value. This disparity would present a real threat of a financial shortfall to many operators.

In light of these widespread "affiliations" in the cable industry, an affiliate transactions rule could harm the public interest in two crucial ways. First, the rules will limit the incentives for cable operators to invest in existing and new program services. Even a small investment could be the straw that breaks the camel's back, pushing the proportion of "sales" to affiliates above the 25 percent threshold and forcing <u>all</u> the affiliated operators to value the cost of the service at only book value. If this source of financing is eliminated, programmers will likely be forced to seek more costly outside financing; in the end, this will increase the cost and reduce the quality of their programming.

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[7] Discovery, for example, is affiliated with three cable operators: TCI, Cox, and Newhouse.

Second, the proposed affiliate transaction rules will likely increase the pressure on cable operators to shift affiliated programming to a la carte offerings, where their rates would not be subject to regulation. This would be a most undesirable shift for an advertiser-supported programmer such as Discovery. In addition, it would contravene the Commission's desire to be "tier-neutral" in rate regulation and to avoid creating incentives for operators to migrate program services to a la carte offerings.

For the foregoing reasons, affiliate transaction rules are unnecessary and undesirable in the cable industry.

III. CABLE OPERATORS SHOULD BE ALLOWED A RETURN HIGHER THAN 11.25 PERCENT ON BOTH RATEBASE ASSETS AND PROGRAMMING COSTS

In the Report and Order, the Commission established an interim overall rate of return of 11.25 percent to govern future cost-of-service proceedings.[8] The Further Notice requests comment on whether the Commission should establish a different permanent rate of return for regulated cable service.[9] Discovery submits that the 11.25 percent rate of return is insufficient to compensate cable operators for their risks and therefore must be increased. In addition, the markup allowed operators on programming costs should be even larger, for a substantially higher markup on programming would better replicate the pre-regulation incentives that produced the current wealth of quality programming unimaginable ten years ago.

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[8] Report and Order at ¶ 147.

[9] Further Notice at ¶ 305.

The Supreme Court has long held that a just and reasonable rate of return requires a return on equity that will "assure confidence in the financial integrity of the enterprise."[10] Although Discovery has not undertaken any formal analysis of the proposed rate, its recent experience attempting to promote its services has made clear that cable operators do not consider the 11.25 percent rate of return to be sufficient and are acting accordingly. This is of particular concern to a programmer such as Discovery, for cable operators need sufficient financial incentives to invest in the expanded capacity needed to carry new services such as The Learning Channel.

Moreover, the Commission should allow a markup on programming expenses -- the heart and soul of cable service -- well in excess of the 7.5 percent currently contemplated in the benchmark proceeding. Discovery's recent comments in that proceeding demonstrate that this extremely low rate of return provides little incentive for operators to offer subscribers high quality programming services.[11] Discovery's efforts to obtain carriage of both The Discovery Channel and The Learning Channel has demonstrated conclusively to it that operators do not believe that a 7.5 percent markup would provide a sufficiently material incentive. Indeed, the markup earned by operators on investment in programming should exceed the return on such items as cable items. Therefore, the cost-of-service rules should allow for a substantially larger markup on programming costs as well.

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[10] Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

[11] Comments of Discovery, Inc. in MM Docket No. 92-266 (filed June 29, 1994).

In any case, there is absolutely no reason to cap the markup on programming at a level at or below the rate of return allowed on the ratebase and the equipment basket. Hence, in order to promote the growth of the cable industry, Discovery strongly urges the Commission to adopt in its final cost-of-service rules an overall rate of return greater than 11.25 percent and a larger markup on programming costs.

IV. THE COMMISSION SHOULD NOT ADOPT A PRODUCTIVITY OFFSET

In the Further Notice, the Commission also solicits comments on the adoption of a productivity offset.[12] Discovery submits that such an offset is inappropriate in the cable industry and should be eliminated.

First, as the Commission itself has recognized, there is no feasible method to assess productivity in the cable industry. The cable industry is simply too young to gauge whether cable operators will experience productivity gains similar to gains in other communications industries. Consequently, the adoption of a 2 percent offset is, at best, speculative.

Second, the adoption of a productivity offset will merely exacerbate the other disincentives to long term investment in programming that are created by the proposed rules. Where the authorized markups are already insufficient, further mandated rollbacks merely increase the harms. Accordingly, Discovery urges the Commission not to adopt a productivity offset.

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[12] Further Notice at ¶ 319, 322.

V. CONCLUSION

For the foregoing reasons, Discovery respectfully requests that the Commission modify its proposed cost-of-service rules. Specifically, the proposed affiliate transaction rules are inappropriate for the cable industry, and should be rejected. In addition, the Commission should increase the 11.25 percent rate of return and eliminate the productivity offset. These modifications will promote the public interest and better serve the objectives of the Cable Act.

Respectfully submitted,

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